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LEGISLATIVE CHOICES IN THE DEVELOPMENT OF MINERAL RESOURCES

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LEGISLATIVE CHOICES IN THE DEVELOPMENT OF MINERAL RESOURCES

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A. Introduction

1. A nation's mineral wealth, if it remains unknown or undeveloped, contributes no more to the well-being of the people who live above it than if the earth were barren. The ultimate objective of the good mineral development law is thus to put the nation's mineral resources to work for its people. This is not done by hoarding minerals in the ground unused, but by facilitating their wise use. "Wise use" is the true meaning of conservation, and therefore a sound mineral development law must of necessity be a mineral conservation law.

2. A less developed nation needs low cost minerals and fuel for use by its people; it needs the revenues which can be generated by sale of its mineral production to support its government, as well as to provide its economy with purchasing power in foreign markets; it needs capital and "know-how" to find, produce, and market its minerals; and it needs employment opportunities and technical training for its nationals to enable them to develop and administer mineral resources.

3. Most of the less developed countries must attract foreign capital for mineral exploration. Even in more mature countries it is difficult to generate sufficient capital by internal taxation to finance the hazardous gambles which characterize the exploration and development of minerals. The amount of capital required for the mineral exploration of any significant area is exceedingly large. The risk of losing the investment is very high. Many examples can be cited of great expenditures by companies that failed to find a single worthwhile prospect. In Turkey, for instance, a company recently spent $20 million in drilling exploratory wells and withdrew without finding oil in commercial quantities. On a worldwide average, only one exploratory well in ten strikes oil in quantities which justify production, even though this average includes the favorable areas in the mid-East and Libya where the ratio is much better.

4. In a single nation the ratio may be twenty or thirty failures to each discovery. Even if a discovery is made, the capital required for development and exploitation is larger still, as a few examples of success in finding oil will illustrate. The successful search for oil in western Canada shows this balance sheet: At the end of more than ten years of production, the total investment exceeded the total value of all oil produced by more than a billion dollars. It will take fifteen years of production for the initial investment to be recovered. In the Rocky Mountain area of the United States there have been similar results. After a dozen years of successful operation, the total investment still exceeds the total value of production by more than a billion dollars.

5. The risks of loss usually prevent the less-developed nation from investing its own revenues in the search for and development of its minerals. Public officials are understandably reluctant to take the responsibility for spending tax money in drilling wildcat wells or undertaking expensive geophysical operations or sinking mining shafts in doubtful territory, where the odds at best are ten to one against

finding commercial deposits, and where, even if the search succeeds, an amount many times the original exploratory investment must be found and spent for development of the oil field or ore body, and construction of production facilities and transportation systems, refineries, and pipelines to carry the minerals to market. Even in the event of success, few young nations can contemplate a dozen subsequent years of heavy deficits in the development of these resources, such as the experience in western Canada and the Rocky Mountain area of the United States suggests. The relatively few state-owned companies that have succeeded in the risky exploration phase embarked upon it armed with substantial capital, previously accumulated, and were in position to diversify their risks. Lacking such previously acquired capital, it may not be wise or even possible for a less developed nation to borrow money for mineral exploration. In several nations, the initial decision to exclude private capital has been modified after finding that the public funds available for mineral development have not been commensurate with requirements, and the resulting necessity for importation of minerals from foreign countries has added to the nation's foreign exchange problems.

6. The company that risks the savings of its investors in the search for minerals knows that if the search fails, as it probably will, the loss will fall exclusively on it, not on the government. It is entitled to assurance that in the event of success it will not be second-guessed, and the reward that it has earned be expropriated.

7. Our objective is thus to find a legislative formula which will bring about the maximum ultimate recovery of a nation's minerals, under conditions which will yield maximum benefits to its people while affording fair treatment to those who risk their capital to bring this development about.

8. In constructing our formula we can assume, as a starting point, that the central government, and not the surface owner, owns and controls the mineral estate. This is the law in most parts of the world, outside the United States, although in some nations the title to minerals is in a provincial or state government. Thus the mining law is the pronouncement of the government both as sovereign lawmaker and as negotiating proprietor. As sovereign the government can enact and enforce such laws as it pleases, subject only to restrictions self-imposed by its constitution and to such limitations as observance of international law may necessitate. But as a proprietor it may find that these very laws defeat their own objectives if they frighten away the foreign capital which they must attract if the latent mineral resources of the nation are to be developed.

9. In a sense, both the host government and the foreigner who risks money in its mineral development are trustees of the nation's mineral resources. In another sense, they are partners in meeting the competition of other mineral-producing nations in the world market. In still another sense, less frequently articulated, they share a common obligation to the consumers of the world that the minerals upon which all are dependent shall be made available for use at reasonable prices over the longest possible period.

10. In deciding how to draft a successful law dealing with the forces which we have just discussed, the task can be broken down into about a half-dozen major chapters. Perhaps the most orderly procedure is to take up these subjects in the logical order of organization of a statute, in which we will see, as we go along, the interrelationship of these problems, some great, some small.

B. Scope of the law, its relation to other laws, and its administration

11. Starting with the premise that the sovereign owns the minerals and that the law that we are drafting will state the terms upon which those minerals can be

sought and produced, the first considerations are these:

12. What minerals shall be covered? The comments in this paper apply generally to oil and gas, and also to the hard minerals, because the same principles control them all. But the details differ to such an extent that it is desirable that separate statutes deal with petroleum and associated minerals on the one hand, and solid minerals on the other, although they may be administered by a common agency.

13. Who shall be eligible to search for these minerals? Foreign governments and their governmental corporations should not be eligible unless they are made so by special acts of parliament, rather than the general mineral laws. The reasons need no discussion. But otherwise it is good business for the host nation to open the door to nationals of all nations who have the required character, technical competence, and financial means to develop the resources on terms satisfactory to the nation. If the law's purpose is to attract capital and talent, it should not defeat that purpose by excluding those eligible to furnish it. We shall discuss later special problems relating to foreign corporations.

14. What other existing laws limit our freedom in drafting a mining code? Aside from constitutional limitations, some of the things an investor must know are likely to be contained in the tax laws, or the foreign investment law, or perhaps in a treaty which requires preferential treatment for some other nation, for example, with respect to repatriation of profits or in restriction of markets for production.

15. Another important preliminary question must be answered: Who shall administer the mineral laws? With whom shall the investor deal? This is crucial. The best-written law is futile if not administered in a clear-cut line of authority by competent and honest men who are adequately paid. It is wise to dedicate mineral revenues first to the payment of good salaries to good men, before paying the balance to the nation's general treasury. Treat money so dedicated as seed-corn, and it will pay for itself many times over.

16. Let us keep the statute itself simple, as nearly as possible in the generalized form of a constitution, and let it delegate to the administrator the power to fill in the details by his regulations and orders.

C. <u>The "concession" system</u>

17. Two kinds of mineral laws appear on the books: general statutes, under which all contracts with individuals are made, and special laws, each ratifying a single contract. The best plan is the former, a general nondiscriminatory statute which offers the same terms to everyone and attracts the maximum of competitive effort.

18. Let the general statute authorize contracts between the government and the mining or petroleum company, which will define the rights and obligations of both parties, consistently with the boundaries for negotiation fixed in the statute. In this discussion such contracts, of whatever type, are referred to as concessions and those who hold them as concessionaires, simply because these terms are common coinage.

19. There are three stages that a mineral venture must pass through on the way to ultimate success. These are reconnaissance, exploration, and production. (Discussion of the phases that follow if production is successful -- i.e., refining, transportation, and sales, must be postponed to another day, as outside the scope of the present discussion. These will be mentioned only in passing. Indeed space limitations preclude detailed treatment of even the initial phases of the development process.) It is sensible, therefore, to authorize three different successive types of mineral concessions, although the three stages can be combined in one

document. The choice of labels is unimportant so long as the differencies in function are recognized.

Reconnaissance permits.

20. The proper function of a reconnaissance permit is to confer upon the holder a non-exclusive right, for a limited time, to examine the area covered by the permit in order to determine whether or not to proceed further. The permittee needs the right to examine structures and ore bodies, take samples, utilize geophysical and other scientific devices, and perform any other work usual in the preliminary examination of potential petroleum or mining areas. A single reconnaissance permit may properly include as large an area as the applicant identifies in his application, except areas which are within those covered by exploration licenses or exploitation concessions (discussed later). He should have access to maps and nonconfidential data developed by the government, on payment of reasonable charges for such services. The permit does not confer any right to make permanent installations or to produce minerals for use or sale. It does not confer any preferential or other right to the issuance of an exploration license or an exploitation concession, and the government should not be precluded from granting such a license or concession by the existence of a reconnaissance permit covering the same area. The permit is a sort of an entry visa, and the more of these that are applied for and used the better-known will the nation's resources become, and the greater the probability will be that competition for them will develop. Fees should be nominal. The true consideration is full disclosure to the government of the information discovered in the reconnaissance. This ought to remain confidential if the permittee proceeds further and applies for an exploration license.

Exploration licenses.

21. The next step, exploration, is usually a very expensive stage of the operation, while producing little revenue. One who undertakes it must have security of tenure. The exploration license thus must confer upon the holder the exclusive right, within the areas specified in the license, to explore and prospect for the minerals covered by the code. It should permit the use of any exploration method, including the drilling of wells, sinking of shafts, driving of tunnels, making trial runs of materials through treatment plants, and the construction of works and the performance of operations, short of commercial production, as may be necessary to enable the licensee to decide whether or not to apply for an exploitation concession. If production is obtained during the process, perhaps by drilling of additional wells to determine the limits of an oil field after the initial discovery, it can be marketed under a temporary production license. The license must define the area covered, because the right is exclusive. The size of the area, per license, is a matter of policy. Full reports should be filed but should remain confidential. They are the licensee's work product, obtained at great expense, and should not be given to a competitor.

22. The essential point, from the state's viewpoint, is to assure vigorous and diligent exploration. There are several devices that can be used to promote this. One is to authorize the administrator to agree with the concessionaire on a program of required expenditure or work. Another is to require payment of surface rentals, on a gradually increasing scale, on the areas that are not developed, so that it becomes expensive to hold them idle. The purpose of the surface tax is not to exact revenue; this is wholly secondary to the purpose of spurring activity. Another device is to limit the duration of the license to a few years and authorize its renewal only on condition that the licensee relinquish a stated percentage of the area on each renewal, unless he has discovered minerals and qualified for and obtained a long-term exploitation concession.

23. From the concessionaire's standpoint, these points are essential:

(i) The right to occupy the licensed area must be exclusive.

(ii) The exploration license must guarantee the licensee the right to obtain an exploitation concession if he discovers minerals. The terms of the exploration concession to which he may convert his exploration license may, if he desires, be annexed to the license, with the assurance that the terms of the exploitation concession which he earns shall not be amended to his disadvantage.

(iii) If the exploration is unsuccessful, the licensee must have the right to salvage and repatriate his equipment. Second only to the importance of the concessionaire's knowing how he can get into a country to look for minerals is the knowledge of how he can get his equipment out again if he does not find them.

Exploitation concessions.

24. An exploitation concession essentially confers upon the holder the exclusive long-term right, within the area covered by the concession, to develop oil fields or mineral bodies, to produce for market, to refine or beneficiate the minerals produced, to export and sell them in their original or refined form, to select the buyer and means of transportation to market, to negotiate the terms of sale, and to receive payment for them. It carries with it greatly increased financial burdens -- the necessity to develop the oil field or ore body discovered, build gathering systems and provide transportation to market, etc.

25. As to the area which may be included within an exploitation concession as compared to that included within an exploration license, the question is one of policy to which many factors are relevant. If the area in the exploration license is small, there are fewer reasons to require relinquishment of part of it, or as much of it, on conversion to an exploitation concession, than if the licensed area is very large. As to whether or not discovery of minerals in commercial quantities shall be prerequisite to issuance of an exploitation concession, the weight of precendent is in the affirmative, treating the exploitation right as a reward for discovery. But a nation may find very good reasons to issue an exploitation concession to a company bold enough to take on heavy development obligations under it befor it has verified the existence of minerals in commercial quantities.

26. It is useful to include all three phases -- reconnaissance, exploration, and exploitation -- in one concession contract, separating the successive stages into corresponding titles and plainly describing the events which will "trigger" the change in relationship from one status to the other.

D. The principles that ought to control the terms of a concession

27. As to the terms of the concession, particularly an exploitation concession, the parties must each recognize the legitimate objectives of the other. The state rightly seeks the maximum ultimate recovery of an irreplaceable resource under conditions which will be of maximum usefulness to its economy. The concessionaire seeks the maximum financial return upon his investment, and rightly believes that the amount of that return should reflect the very high degree of risk which the investment entailed.

28. But there is one principle that ought to govern the thinking of both the state and its concessionaire in bargaining about their respective shares in the mineral wealth that both of them hope will be found and produced. The common purpose ought to be to bring about the maximum ultimate recovery of the mineral resource and to market that production at prices which will assure its entry into

the world market at competitive but profitable levels. This requires some mutual adjustments. If the concession has a short term, the pressure is on the concessionaire to get out all he can, as cheaply as possible, even by production methods that leave a large part of the resource permanently unrecoverable. To the extent that he is assured long tenure that pressure is lessened. On the other hand, the two-fold curse of many mining countries is, first, the speculator who gets control of a mining claim or "denouncement" merely for the purpose of holding up development of a larger area until he is bought out, and, second, the concessionaire who has control of a second ore deposit in another country that he prefers to produce while holding the first as inactive as possible. To some degree these problems can be met in the statute's requirements for development expenditures, previously discussed, and in its financial provisions, to which we now turn.

E. Financial matters

29. The state's financial gain from the development of its mineral wealth can take one or more of several forms. Some of these, and the reasons which should control their selection or rejection, are considered below. Simply to catalog them underscores what was said earlier, that the attraction of a new mineral industry to an undeveloped country may be affected less by the content of the mineral laws than by what is found in other controlling statutes.

30. Import and export duties on equipment. These should be rejected. It is to the nation's interest to attract all the tools that are obtainable, on the assurance that when they have served their purpose they can be taken home again.

31. Bonuses. These are lump sum payments obtainable on competitive bidding for exploration licenses or exploitation concessions in favorable areas. Manifestly their availability is in proportion to the attractiveness of the area.

32. Surface taxes. Their proper purpose is not to obtain revenue, but to penalize idleness and reward diligence in looking for and producing minerals. For that reason they should apply only to areas on which no development has been attempted, and should be increased by a pre-set scale in successive periods of years. If development is diligent, the development expenditure may stand in the place of surface taxes.

33. Annual lump-sum minimum payments. These are negotiable.

34. Royalties. These are percentages of the gross value of the product, payable in cash or as a share of production, "in kind." The rates are negotiable, but it should be remembered that royalties are exactions from gross revenue, not net income, and hence may be payable even if the concession operates at a loss.

35. Export taxes. These tend to defeat their purpose by burdening the country's production in competition with that of other nations.

36. Ad valorem taxes. Mining investments, like investments in public utilities, are characteristically very heavy, per dollar of revenue produced; unlike public utilities, however, the rate of return on that investment cannot be guaranteed. To the contrary, mineral prices are characteristically volatile, and even if prices remain stable the amortization of the investment is dependent upon the size of the mineral deposit, which may be a highly uncertain factor. Mining ventures are an inviting target for ad valorem taxation, because the target is so large and visible but they are peculiarly susceptible to the anemia which fixed-level taxation can produce in an industry so highly dependent on variables that are beyond the control of management. For this reason, the profit-sharing device, to which we will come in a moment, is an attractive substitute.

37. Income taxes. The corporate income tax, of progressively increasing rates, and its concomitant, the tax on dividends, are almost universal; but there is a refinement available, to which we now turn.

38. Profit-sharing agreements. There is a growing tendency in mineral legislation toward profit-sharing agreements between the state and the concessionaire as a substitute for all forms of taxation. The simplest device is to state a tax at the agreed rate on net income, declare that this replaces all other taxes of every description, and to provide that royalties or agreed minimum annual payments shall be credited against that tax, or, if in excess of the tax, credited against the tax otherwise payable in later years. This automatically puts the nation and the producer in step toward what should be their common objective, marketing the maximum ultimate recovery at the best price obtainable.

39. The profit-sharing device also provides a vehicle for attaining an objective which nearly all undeveloped countries nourish: the hope that domestic capital can be found to participate to some extent in the nation's mineral development so that it will not be wholly dependent upon foreigners. A common proposal is that the concessionaire must be a domestic corporation, and that a majority or a stated per cent of its stock be locally owned. This usually defeats its purpose, for two reasons: First, to the extent that such a provision excludes foreign capital, mineral development is retarded. If this were not so, the simple solution would be to prohibit foreign investments altogether. Where this latter extreme has been reached, more of the nation's minerals have indeed remained safe in the ground, but the people have had correspondingly small benefit from them. Second, the tax laws of the concessionaire's country of origin may require that, in order for such a company to offset losses in one country against profits in another in the calculation of income taxes payable at home, it shall operate in both countries as a single corporation, or, if operating through separate corporations, that they be wholly owned by the taxpayer.

40. But there is a solution. It is justifiable for the state, speaking as proprietor as well as tax-collector, to provide that if a profit-sharing agreement is negotiated, displacing all taxes, more favorable terms will be granted in such an agreement to concessionaires who facilitate participation in the venture by local capital than to those who do not. Participation does not necessarily mean ownership of stock of the concessionaire. It can mean an association between two corporations, one foreign owned, one domestically owned.

41. Some other financial problems require mention. One of the most serious is the concessionaire's right to sell his production in any market for any currency, and convert it into the currency of his choice; and the related right to repatriate profits freely, and capital as well in the event of liquidation or sale of the venture. To the extent that this freedom is restricted, by whatever laws -- whether the mineral laws, investment laws, foreign exchange controls, or "zone" accords with favored nations -- the nation restricts the competitive attractiveness of its minerals to the investor.

42. Another problem is the right of surrender. No concessionaire will voluntarily surrender a profitable concession, but if he cannot make a go of it, he should not only be permitted, but encouraged, to take his equipment and leave (provided that debts are paid and formations protected), so that a successor can be placed in possession of the area.

43. Another is the problem of pricing of mineral production for the calculation of royalties or of the state's agreed percentage of profits. Where production is sold in the open competitive market, the impersonal market solves the problem; both the state and the concessionaire must take the bitter with the sweet, in simultaneous doses. But where the concessionaire consumes the minerals, in one stage in an integrated operation, or controls the world market in some degree, or sells to an

affiliated company at a price not negotiated at "arm's length," there is the possibility of trouble. Both sides, therefore, have an interest in plainly stating criteria of values and providing standards of disclosure in the concession agreement, to avoid such misunderstandings. The greater the degree of candid exchange of information between the concessionaire and the government, the less likely these collisions will become.

F. Arbitration and judicial review

44. A sensitive subject is the procedure for settlement of disputes between the sovereign and the concessionaire. Differences and disagreements are bound to arise. Exploitation concessions usually operate long after the life expectancies of the men who negotiated them, and under conditions that no one could have foreseen. Most of the necessary adjustments are made amicably, most of the disagreements are settled. But these accommodations are facilitated if the parties know that both of them have recourse to an impartial tribunal to resolve a dispute that cannot be settled by agreement. Moreover, there is a natural fear on the part of investors that political upheavals in a distant land may result in the expropriation of their investment. Their willingness to invest is directly proportional to their confidence in the sovereign's fidelity to their agreement and in availability of an independent judiciary to enforce that agreement, irrespective of political changes.

45. A new nation, by hypothesis, has not yet had time to establish its reputation for honoring its contracts, nor time to demonstrate the independence of its judicial system. But it is understandably reluctant about conceding either of these things. This is no reproach to the new nation, for the doctrine of sovereign immunity is a shield behind which some very old nations have sometimes retreated when sued for the violation of their agreements, even though the courts in which they refused to litigate were their own.

46. Two alternative devices are available for solving this delicate problem. One is a provision in the statute and concession to authorize international arbitration of major issues between the sovereign and a foreign company, or company whose stock is owned by foreigners. By "international arbitration" is meant the selection of a sole arbitrator, or the neutral arbitrator if each party also appoints one, from a nation which is foreign to both disputants; or, failing agreement upon such a person, his appointment by some recognized international judicial agency, such as the Permanent Court of International Justice. Under this procedure the award is enforceable as a judgment.

47. Another device is provision in the statute for creation of a special court or board of concession appeals, which, although appointed by the sovereign, is made up of distinguished foreign jurists whose names are known before the concession is signed.

48. There is no perfect solution for the problem of resolving disagreements under a mineral concession, just as there is no perfect way of writing an agreement which will be forever free of misunderstanding. But the sensible thing is to recognize that a long-term mineral development agreement, international in the sense that it is a device to enlist the resources of one nation in the development of the resources of another, requires international judicial machinery of some kind to enable it to function equitably. Such an agreement is peculiarly susceptible to the generation of differences in viewpoint. These arise in the beginning out of difficulties of language in the expression of a "meeting of the minds," and later in the application of the agreement to conditions that may change drastically as the very consequence of its successful operation, resulting sometimes in great changes in the host nation's economy, its way of life, and its politics.

G. Conclusion

49. The successful mineral laws of the world -- we have examined those of over a hundred jurisdictions -- all apply certain principles in common, irrespective of details.

50. The first principle is a fair allocation of risk and profit. The risk, in all cases, is upon whomsoever provides the capital. The investor will risk his savings only if there is a possibility of profit commensurate with the risk, which in the mineral industries is very great. On the other hand, the state is acting as guardian of an irreplaceable resource and must insist that that resource make the maximum contribution to the nation's economy, present and future.

51. The state is usually both proprietor and sovereign in the areas of the world we are now considering. Where one side to a bargain is both the law giver and the owner of the property to be developed, its power is so great that the only restraint upon it may be self-restraint, and the duty to exercise self-restraint is correspondingly increased. Conversely, where the technical know-how, the financial resources necessary for mineral development, and perhaps the access to markets, are in the hands of the concessionaire and not the government, it too is a guardian of the interests of the state as well as its own interests, and owes a corresponding duty to exercise its economic power honorably.

52. These principles, although sometimes differently stated, are recognizable in every system of law under which the mineral resources of the world are being developed successfully. This pattern is reflected in the maxim of the Roman law, "pacta sunt servanda;" in that of the common law which describes a contract as "the law of the parties;" in the Muslim law, "Muslims are bound by their stipulations;" and is carried over into the international law which every civilized community recognizes. This is not to say that a state does not possess rights of nationalization, but a state defeats its own purposes if these sovereign powers are exercised otherwise than by judicial means followed by prompt and adequate compensation. A concessionaire likewise defeats his own purposes if he fails to recognize his status as a trustee charged with effecting the maximum ultimate usefulness of the nation's irreplaceable minerals.

53. The less developed nations are competing for the accumulated savings of the investors of the world in order to provide the means to search for and develop their resources; and they are also competing for the markets of the world, into which to move those resources if the search is successful.

54. In this dynamic age, the age of minerals as some have called it, no nation is a law nto itself. When we extract and consume minerals, we are reducing the planet's fixed and irreplaceable endowment, living on capital, not income. Therefore all of us, whether producer or consumer, whether living in a nation that exports capital and technical skills or a nation that receives these and puts them to use, have inseparable stakes in the wisdom of the mineral development laws of every part of the world.

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